Don't Abolish the AMT

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The Wall Street Journal Opinion
May 2, 2007

In the late 1970s, supply-side economists and journalists, many of them writing on this page, began and won a debate in economics. Their insight was that high marginal tax rates put a large "tax wedge" between the income people get from earnings and investments and the value that society places on the output of those investments, and that this stunts economic growth by discouraging earning and investing.

It wasn't a novel insight; James Mirrlees, an economist who had analyzed tax rates in Britain in the 1970s and who advised the Labour Party, concluded that the top marginal tax rate should be about 20%. But he published his conclusion only in a technical economics journal and therefore didn't affect popular thinking. (Though he was co-winner of the 1996 Nobel Prize in economics.)

But when supply-siders came along and "went public," it did become widely understood that tax rates have a direct link to economic growth. And only then did mainstream academic economists examine empirically the supply-siders' claims and find that the more moderate of these claims were correct.

For that reason, supply-siders should now be leading the effort to reform the Alternative Minimum Tax in a way that encourages economic growth. And they could do so in a way that, over time, turns the AMT into a taxpayer-friendly, flat tax rate for the middle class.

The wrong reform, from the viewpoint of incentives, is the one congressional Democrats and many others advocate: Raising the income threshold at which the AMT kicks in, making up the revenue loss by raising AMT tax rates on high-income people and on dividends and capital gains.

The right reform is to tweak the AMT around the edges so that more and more people will face lower marginal tax rates. The AMT has been rightly called a "stealth tax" because so few people are aware of it until it reaches out and bites them. But it's also a modified flat tax rate, and further reforms should make it flatter and lower. That way, even moderate inflation could "stealthily" move us, over about 10 years or so, to a flat tax for most Americans.

Consider how the AMT works. First, you compute your tax liability under the standard tax rules. Then you compute it under the AMT. You pay the greater of the two; minimum does not mean minimal. There are two main differences between the standard tax system and the AMT. The first is the structure of tax rates. Under the standard tax system, you get a relatively small basic deduction ($10,700 in 2007 for married taxpayers filing jointly), and then the marginal tax rates rise with income, starting at 10% and going, in steps, up to 35%. Under the AMT, by contrast, there is no basic deduction. Instead, the first $45,000 of income is exempt for a married couple filing jointly and there are only two tax rates on taxable income, starting at 26% and rising to 28%. Second, many deductions that you can take under the standard tax system are prohibited under the AMT. These deductions include the per-person deduction and the deduction for state and local taxes. That's why, all other things being equal, the AMT hits large families in high-tax states more heavily.

Notice something interesting? The Alternative Minimum Tax sounds a lot like a flat tax rate, at least the kind that has been advocated in the U.S. In this country, most advocates want two rates: 0% on the first X amount of income with a deduction for each family member, and then a single rate, typically about 19%, on all income above this exempt amount. "Flat tax" advocates also want minimal, if any, deductions, whether for state and local taxes or for mortgage interest or for anything else. The current AMT differs from this "flat tax" system in three main ways. The basic exemption is higher, the marginal tax rates are higher and the AMT allows deductions for expenses that would not be allowed in a flat-tax regime.

If a flat-tax rate regime is desirable, then the sensible reform would be to modify the AMT to get it closer to a flat tax. The three ways to do so, as the above comparison suggests, would be to *reduce* the exempt level below $45,000, *reduce* the AMT's marginal tax rates and further *limit* the items that are deductible. Thus, raising the exempt income level for the AMT, as Congress has done on an ad hoc basis every so often and as many taxpayers want it to do again this year, is exactly the wrong way to go. Lowering the exempt income below $45,000 is probably not feasible politically. But leaving it at the current level is feasible. Because even an inflation rate of 3% will erode this exempt amount by 26% in 10 years, inflation would slowly move a higher and higher percentage of U.S. taxpayers toward a flat tax-rate system.

But 26% and 28% are high tax rates for a flat-tax system. So -- and here's the good news for taxpayers -- another reform of the AMT should be to lower these rates to one rate, say 24% or even 20%. Although few people remember this now, the AMT rate as recently as 1986 *was* 20%. Then President Reagan and Congress raised it to 21% with the 1986 Tax Reform Act; President Bush and Congress raised it to 24% in the 1990 tax bill; and in the1993 tax bill President Clinton and Congress imposed rates of 26% and 28%. Along with lower rates could go a further limitation on deductible expenses, again a longtime goal of advocates of flat tax rates. All of these reforms could be done so that the federal government gets the same revenue it would have had absent these reforms.

But *why* is a flat tax rate desirable? First, as supply-siders have emphasized, it has a positive effect on the incentives to earn, save and invest. The lower the marginal rate, the stronger those incentives. Someone deciding to take a promotion or a job in a remote area, for example, will be more likely to do so in response to the increased pay if he or she gets to keep a larger percentage of that additional pay. Critics of the supply-siders have admitted that the marginal dollars kept are an incentive to earn more income. But, they argue, cuts in tax rates throughout the brackets make the taxpayer better off, and he may use this higher real income to "buy" leisure -- that is, work less. But this criticism does not apply to my proposal because, as noted, the AMT could be changed to keep the federal government's revenues constant. In economics jargon, the system could be changed so that there is a substitution effect (working harder in response to higher after-tax incentives), but no income effect (that is, working less hard because of the tax break on non-marginal dollars). The net effect would be more work and more output.

A flat tax rate is also desirable because it gives lower-income people a disincentive to advocate more federal government programs, because they will see themselves as paying for those programs. On a state level it gives people, especially those with higher incomes, a reason not to support creating more state and local government programs, because they no longer will be able to deduct their state tax bills from their federally taxable income.

And finally, taking roughly the same percentage of everyone's income is more fair.

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